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World Economy: Moving Into Recovery ¹

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After three years of slump, the world economy appears on the verge of recovery. There are a number of obstacles to a strong rebound, but we believe world economic growth in 1983 could be stronger than foreseen in many recent forecasts. To some extent, the recovery path will depend on the demand management policy stances of OECD governments. At present, both fiscal and monetary policies are tight in most countries; some relaxation—particularly of monetary policy—may be needed to support a more rapid recovery.

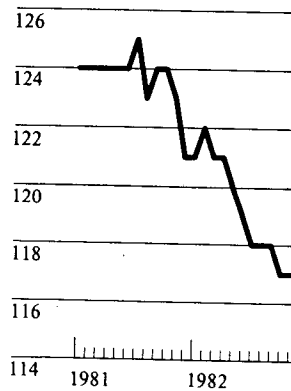
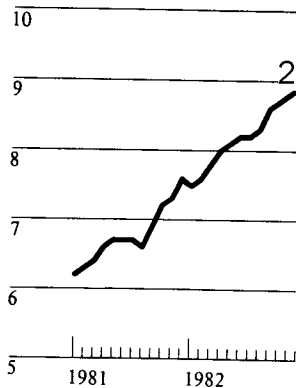
Signs the Slump Is Over

A number of signs have emerged that indicate the 1980-82 world recession has bottomed out. In the OECD:

- According to the IMF data, OECD-wide industrial production stopped declining in late 1982; even where decline continued, notably in some West European countries, the pace slowed from that of earlier months.²
- According to both the OECD Secretariat and the US Conference Board, leading indicators of industrial production are up for recent months in most OECD countries.

In the LDCs, sketchy, end-of-1982 data indicate that their domestic situations are not as close to recovery as are those in the OECD. On the other hand, the “free-falls” their economies were in during much of 1982 may be nearing an end.

¹ This article provides an overview of the factors that will play important roles in 1983 world economic trends; a forthcoming intelligence assessment will provide greater detail on our expectations on the course of recovery, particularly in the OECD countries.
² Data presented in this article were obtained primarily from OECD and IMF statistical publications.

OECD Countries: Economic Indicators^aIndustrial Production
Index: 1975=100Unemployment
Percent of Labor Force^a Seasonally adjusted.

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Underlying Factors

The bottoming out of the slump is attributable to a number of influences. One key factor has been the greater-than-expected slowdown in world inflation, that the recession triggered. While wage gains have also been pulled down, the decline in price inflation has been greater in a number of key OECD countries. As a result, real wages rose in 1982 for the first time in three years; it appears that much of the increase occurred later in the year. This improvement in real wages is enabling consumers to

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increase their real expenditures. At the same time, the leveling off of unemployment in some countries probably is increasing their willingness to do so. ☐

A second factor in the turnaround has been the fall in oil payments from the OECD and non-OPEC LDCs to OPEC—a decline that conservation and substitution have caused to far outpace the drop that would have been dictated by the world recession alone. In 1982 these payments to OPEC by the rest of the world declined by \$60 billion; the so-called Low-Absorbers of OPEC—chiefly the Persian Gulf states—shouldered more than \$40 billion of the decline. This shift in world spending flows is, in effect, leaving additional spending power equal to between 0.5 and 1 percent of world GNP in the hands of Western and non-OPEC LDC businesses and consumers—groups with a much higher propensity to spend than the OPEC countries. ☐

A third factor that seems to have played some role in the bottoming out has been a relaxation of monetary policy in three of the Big Seven OECD countries:

- In the United States the Federal Reserve's discount rate has been cut from 14 percent in late 1981 to 8.5 percent; growth of the primary monetary aggregates has accelerated to or above the high end of the Fed's target range for monetary expansion.
- In West Germany the central bank money stock has recently been allowed to grow at the upper end of the Bundesbank 4-7 percent target range; in 1981 its growth was held to the low end of that range. Concurrently, the Lombard rate has been cut from 7.5 to 5 percent.
- In the United Kingdom, sterling M3—the money stock definition traditionally used in the Bank of England's policy formulations—has increased more rapidly in recent months, but the government claims that this is due to technical factors rather than a change in policy. ☐

Speed of Recovery

The speed of the recovery will depend on a variety of influences. A number of factors are likely to hold it back:

- **Stock Adjustment.** Stock overhangs in Japan and Western Europe likely will retard first-half 1983 production gains as business relies on inventories to meet increases in demand. In Japan, stockbuilding accelerated last year despite slower growth of final demand. Of the four largest West European countries, only in the United Kingdom were stocks actually drawn down; in West Germany and France, stockbuilding accelerated sharply.
- **Structural Problems in Industry.** The depressing effect of slack capacity on business investment is compounded by structural problems. The production declines in many old-line industries, most notably iron and steel, have been so severe that disinvestment in these sectors may offset investment rebounds in stronger industries.
- **No LDC Import Growth.** Imports by LDCs cannot be counted on to provide impetus to OECD growth as in the 1975-76 recovery. The widespread financial problems in these countries resulted in a 1-percent drop in import volume last year after 9-percent growth in 1981. Continuation of the debt problems and the impact of IMF-mandated austerity programs are expected to lead to, at best, no import volume growth again this year. We estimate that the zero import volume increases in the LDCs, instead of a more typical 5-percent expansion of imports, will cost the OECD between 0.5 and 1.0 percentage point in growth.
- **High Long-Term Interest Rates.** Long-term interest rates remain high, depressing both business fixed investment and household investment expenditures. While short-term rates have fallen, the trend in longer term rates is more important

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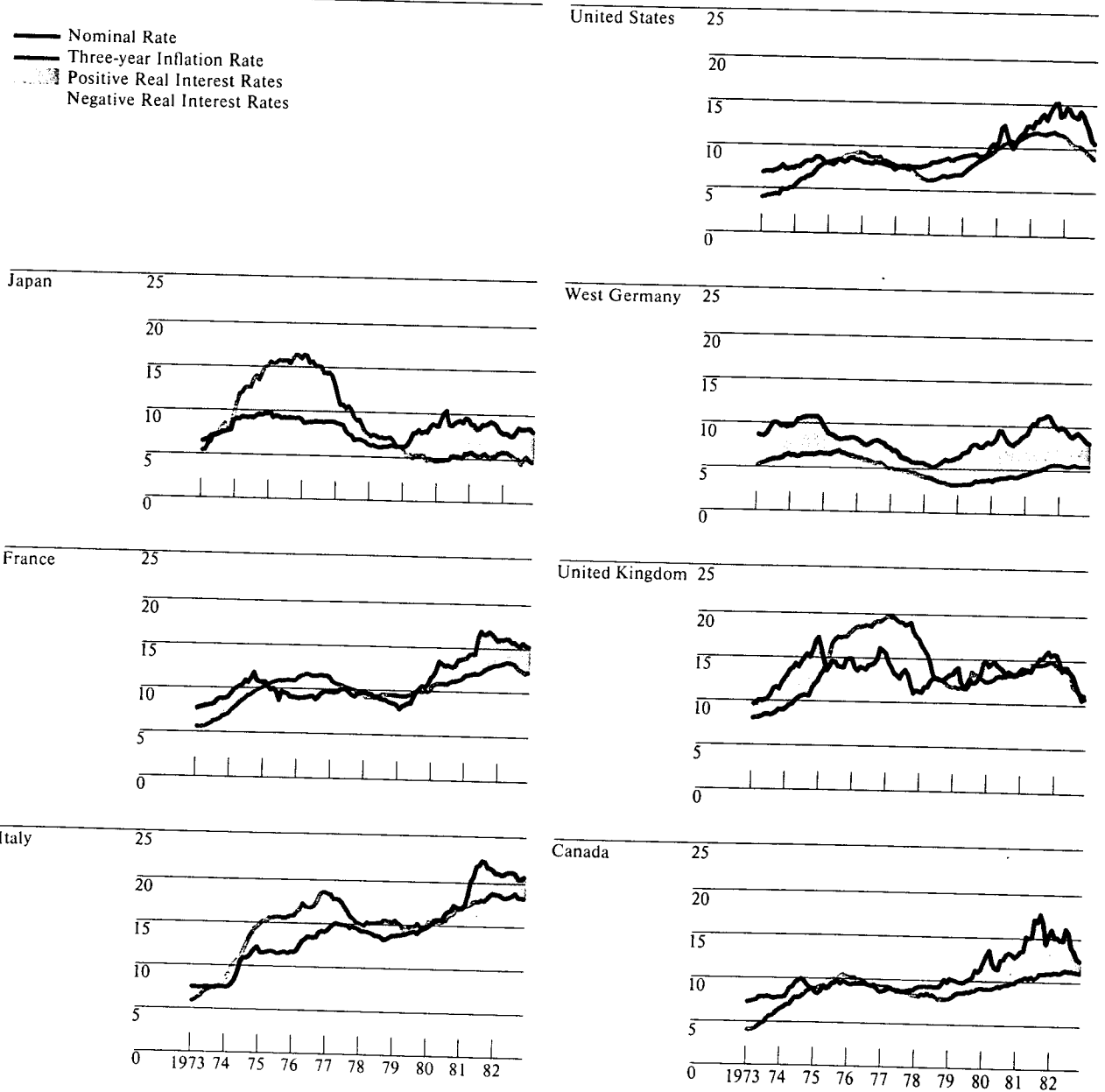
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Big Seven Countries: Long-Term Interest Rates

Percent

— Nominal Rate
 — Three-year Inflation Rate
 Positive Real Interest Rates
 Negative Real Interest Rates



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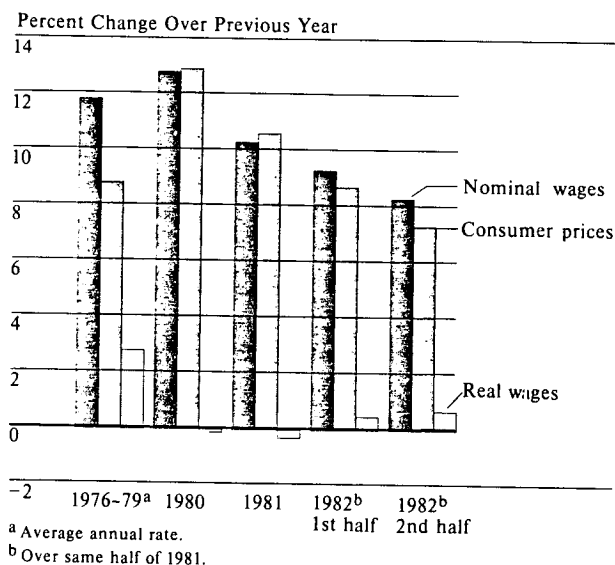
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OECD Countries: Real Wages



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for major fixed investment decisions such as installation of plant and equipment or housing construction. In several of the major OECD countries, real long-term rates are down only slightly from the 1982 peak. []

An additional constraint on recovery in 1983 may be the recent spread of protectionist measures. The impact of this factor on the world economy is difficult to quantify, but, because world economic expansion has depended heavily on increasing trade, protectionism probably is providing an additional small hurdle to recovery. []

Finally, OECD fiscal policies have remained tight. Except for France, Italy, and Canada, the fiscal policies of the Big Seven are designed to trim government deficits. []

Some Positive Signs

The presence of these negative influences probably will prevent a robust world economic recovery of the 1975-76 variety, when OECD real GNP increased at more than a 5-percent annual rate in the first 18 months of recovery. There are, however, some positive signs:

- First, the US economy seems to be coming off the mark faster than expected late last year. In its December 1982 Economic Outlook, for instance, the OECD called for 2-percent first-half 1983 growth in the United States. The Department of Commerce now estimates a 4-percent growth rate in the first quarter, and Data Resources Incorporated calls for essentially as strong growth in the second quarter. []
- A second encouraging factor is the slide in oil prices. Energy-producing sectors—and their investment spending—will be depressed by continuing oil price declines, but most other sectors will benefit. We estimate that each \$1 drop in OPEC's oil price leaves \$6 billion in the hands of non-OPEC consumers and businesses. []

Government Policy Options

A third factor that could help boost growth would be a further shift in demand management policies in key OECD countries, as occurred in the mid-1970s. Looser fiscal policy is not considered by most OECD governments to be economically or politically practical. Japan, the United Kingdom, and a few small West European countries, nevertheless, may have room to adopt more expansionary fiscal measures.³ Moreover, some relaxation of monetary policy is likely, particularly if US interest rates decline further. []

³ A forthcoming intelligence assessment will examine in detail the fiscal policy options and constraints of key OECD governments. []

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**World Economy: Government Policies
in the Mid-1970s**

By early 1975 the OECD economies had sunk to depths akin to, although not as severe as, those currently being experienced. Demand management policies during 1974-75 were tight on both the fiscal and monetary fronts:

- In 1974 the combined government budget deficits of the Big Seven countries widened by only 0.7 percent of GNP, despite just 0.7 percent real growth. In the two largest economies—the United States and Japan—the tightness of fiscal policy was more pronounced than for the OECD as a whole.
- OECD monetary policy also turned tighter in 1974 as money stock expansion rates were cut sharply from the rapid pace of 1971-73.

Expansionary Policies in 1975-76

These contractionary policies were significantly modified during 1975 and 1976. Budget deficits were allowed to increase sharply in 1975 and remain high in 1976 even though economic recovery proceeded rapidly. More rapid expansion of demand also was supported by a looser monetary policy in most OECD countries.

The strongest shifts to expansionary policies were in the United States—where money supplies grew at about double the 1974 rate and the 1975-76 budget deficits ran about 3 percent of GNP higher than in 1974. West Germany also allowed a substantial rise in money stock growth and budget deficits.

Response to Stimulus: Growth and Inflation

The policy modifications of 1975-76 coincided with a reversal of real output trends. OECD real

output rose at more than a 5-percent pace in late 1975 and 1976. Nearly all OECD countries shared in this rebound. Moreover, the growth slump in the non-OPEC LDCs bottomed out and was reversed in the OPEC countries.

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The initial inflation costs of the robust economic recovery were low. OECD inflation continued to decelerate through the end of 1976; 20 of the 24 OECD countries had lower inflation in late 1976 than they did at the trough of the 1974-75 recession.

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Several factors combined to provide the deceleration of inflation:

- Continued slack in world oil markets kept oil prices steady. 25X1
- Nonoil commodity prices also increased only moderately.
- Most important, inflationary pressures from the wage side diminished considerably. Despite the onset of recovery, wage increases remained moderate as a result of still-high unemployment; the sharp gains in productivity that occurred as the economies rebounded also held down price pressures. 25X1

Despite the continued steady expansion of world economic activity in the intervening years, it was not until 1979 that there was a major reacceleration of global inflation pressures brought on by:

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- Continuation of expansionary policies as capacity output levels were approached.
 - Spillover impacts from US inflation.
 - The initial impacts of Oil Shock II. 25X1
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Secret**World Economy:
Changes in Real GNP and Prices***Percent*

	1973	1974	1975	1976	1977	1978	1979
OECD							
Real GNP	6.1	0.7	-0.2	4.8	3.8	4.0	3.1
Consumer prices	7.8	13.4	11.3	8.7	8.9	8.0	9.8
United States							
Real GNP	5.5	-0.7	-0.7	4.9	5.5	5.0	2.8
Consumer prices	6.2	11.0	9.1	5.8	6.5	7.7	11.3
Japan							
Real GNP	8.8	-1.0	2.3	5.3	5.3	5.0	5.1
Consumer prices	11.7	24.5	11.8	9.3	8.1	3.8	3.6
Canada							
Real GNP	7.5	3.5	1.1	5.8	2.4	3.9	3.2
Consumer prices	7.6	10.8	10.8	7.5	8.0	9.0	9.1
Western Europe							
Real GNP	5.8	2.1	-0.8	4.6	2.4	3.0	3.2
Consumer prices	7.9	12.0	13.3	11.4	11.6	9.7	10.7
West Germany							
Real GNP	4.5	0.7	-1.6	5.4	3.1	3.1	4.1
Consumer prices	6.9	7.0	6.0	4.5	3.7	2.4	4.1
France							
Real GNP	5.4	3.2	0.2	5.2	3.1	3.8	3.3
Consumer prices	7.3	13.7	11.8	9.6	9.4	9.1	10.8
United Kingdom							
Real GNP	7.5	-1.0	-0.7	3.6	1.3	3.7	1.6
Consumer prices	9.2	16.0	24.2	16.5	15.8	8.3	13.4
Italy							
Real GNP	7.0	4.1	-3.6	5.9	1.9	2.7	4.9
Consumer prices	10.8	19.1	17.0	16.8	18.4	12.1	14.8
LDCs							
Real GNP	8.9	7.1	4.5	6.5	6.3	4.7	5.1
Consumer prices	20.9	30.1	31.6	42.3	29.1	24.1	31.1
OPEC							
Real GNP	12.1	9.1	3.9	10.1	8.2	1.1	4.0
Consumer prices	13.2	19.0	21.3	18.9	12.2	18.7	11.9
Non-OPEC							
Real GNP	7.7	6.4	4.7	5.1	5.5	6.2	5.5
Consumer prices	23.7	31.1	35.4	51.0	35.4	29.9	38.3
Factor Prices							
Oil	15.0	233.0	-2.4	6.8	9.4	0.4	44.4
Food	54.0	60.2	-21.2	-18.4	-3.7	14.0	14.1
Agricultural raw materials	79.2	-3.6	-19.7	24.2	3.2	7.6	22.0
Metals	46.9	24.9	-19.4	6.0	7.4	5.5	29.8

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OECD: Money Supply and Budget Deficits

	1973	1974	1975	1976	1977	1978	1979
OECD ^a							
Budget deficit (<i>percent of GNP</i>)	0	-0.7	-5.4	-3.0	-2.3	-2.4	-1.9
M2 (<i>percent change</i>)	14.0	10.8	11.9	13.6	11.9	10.5	10.7
United States							
Budget deficit (<i>percent of GNP</i>)	0.5	-0.2	-4.2	-2.1	-1.0	0	0.5
M2 (<i>percent change</i>)	6.6	4.7	9.0	11.4	11.0	5.6	6.5
Japan							
Budget deficit (<i>percent of GNP</i>)	0.5	0.4	-2.7	-3.7	-3.8	-5.5	-4.8
M2 (<i>percent change</i>)	22.2	12.6	12.6	15.1	11.5	12.1	11.0
Western Europe ^b							
Budget deficit (<i>percent of GNP</i>)	-0.9	-2.1	-5.5	-3.9	-3.0	-3.9	-3.4
M2 (<i>percent change</i>)	17.1	14.7	13.8	14.6	12.8	14.4	13.7
West Germany							
Budget deficit (<i>percent of GNP</i>)	1.2	-1.4	-5.7	-3.6	-2.4	-2.6	-2.9
M2 (<i>percent change</i>)	10.5	7.1	9.4	10.1	8.6	10.0	8.2
France							
Budget deficit (<i>percent of GNP</i>)	0.9	0.6	-2.2	-0.5	-0.8	-1.8	-0.7
M2 (<i>percent change</i>)	14.2	17.2	15.0	16.0	12.4	13.5	13.4
United Kingdom							
Budget deficit (<i>percent of GNP</i>)	-2.7	-3.7	-4.6	-4.9	-3.1	-4.3	-3.1
M2 (<i>percent change</i>) ^c	27.2	10.2	10.8	9.4	10.3	15.2	12.7
Italy							
Budget deficit (<i>percent of GNP</i>)	-5.8	-5.4	-11.7	-9.0	-8.0	-9.7	-9.3
M2 (<i>percent change</i>)	20.9	20.0	20.9	22.0	21.4	23.0	19.1
Canada							
Budget deficit (<i>percent of GNP</i>)	1.0	1.9	-2.4	-1.7	-2.6	-3.1	-1.9
M2 (<i>percent change</i>)	15.6	24.2	14.4	19.0	15.3	14.0	18.7

^a Big Seven only for budget deficit.^b Big Four only for budget deficit.^c Sterling M3 balances.

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Implications

The benefits of something more than flat or minimal real GNP growth this year would be widespread. The most important benefit likely to come from more rapid growth will occur in the debt-troubled LDCs. Each 1-percentage-point increase in OECD real GNP will add \$5 billion to LDC export earnings and, in turn, reduce financing needs. While credit relief for many LDCs is necessary in the short run, their debt problems can be solved over the longer run only through increased world demand for their products.

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